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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 723

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

NATIONAL GROCERY COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

REPLY BRIEF FOR THE PETITIONER

SECTION 104 OF THE REVENUE ACT OF 1928 IS A VALID EXERCISE OF LEGISLATIVE POWER

The respondent contends (Br. 40–61) that Section 104 is not within the competence of Congress, with the result that Congress is impotent to deal with so flagrant a purpose to avoid the imposition of surtaxes as is presented in the case at bar. Its contention is fivefold: First, that the tax in question is not a tax on income, but a direct tax on a purpose or state of mind (Br. 40–45); secondly, that it is not an income tax within the meaning of the Sixteenth Amendment, but a penalty designed

to force corporations to distribute their earnings, in order to create a basis for taxation of such distributions in the hands of their stockholders, and hence merely an attempt "to control and regulate the dividend policy of domestic corporations" (Br. 45–55); thirdly, that the Act violates the Tenth Amendment, but only so far as it applies to operating companies, it being conceded that it is valid as to holding companies *formed* for such purpose (Br. 55–61); fourthly, that the tax deprives the respondent of its property without due process of law in contravention of the Fifth Amendment, in that the statutory classification furnishes no definite and certain criteria for ascertaining when the incidence of the tax will fall upon operating companies (Br. 62–65); and, lastly, that it involves an unconstitutional delegation of legislative power.

Each of these contentions has been disposed of by lower appellate courts. *United Business Corp.* v. *Commissioner,* 62 F. (2d) 754 (C. C. A. 2d), certiorari denied 290 U. S. 635; *Williams Inv. Co.* v. *United States,* 3 F. Supp. 225 (C. Cls.); *A. D. Saenger, Inc.* v. *Commissioner,* 84 F. (2d) 23 (C. C. A. 5th), certiorari denied, 299 U. S. 577; *Keck Inv. Co.* v. *Commissioner,* 77 F. (2d) 244 (C. C. A. 9th), certiorari denied, 296 U. S. 633; *Almours Securities* v. *Commissioner,* 91 F. (2d) 427 (C. C. A. 5th), certiorari denied, January 10, 1938. Following the decision in the *Williams Inv. Co.* case, the Court

denied certiorari in the *United Business Corp.* case, even though the Government did not oppose the granting of the writ, the decision being the first to dispose of the constitutional objections. In the *United Business Corp.*, the *Keck*, and the *Almours* cases, the taxpayers pressed upon the Court every possible objection to the validity of the statute. And, in the *Almours* case, this Court denied a petition for rehearing of the denial of certiorari while the petition of the Government was pending in the case at bar (Journal, February 7, 1938, p. 162).

As already noted, the respondent admits (Br. 55–56) that it was competent for Congress to impose this tax in respect of corporations *formed* for the purpose of avoiding the surtax; respondent contends only that Congress is impotent to protect the fisc against availance of *operating* companies for the interdicted purpose. Indeed, it is argued that Congress did not intend to impose this tax upon operating companies, and that the legislative history so shows. It is submitted that there is nothing whatever in that history to justify such a conclusion, and certainly there is nothing in the plain provisions of the statute which does. It provides that the tax shall be levied upon all corporations however formed. It would indeed have been strange had Congress limited the tax to holding companies and actually exempted operating companies therefrom even though they were avowedly

availed of for the interdicted purpose. Congress has never done that.[1]

The provisions of the statute may be justified upon two grounds: First upon the ground that they impose a special income tax and, secondly, upon the ground that they are necessary to implement the provisions of the law in order to prevent tax avoidance.

(A) THE STATUTE IMPOSES A SPECIAL INCOME TAX

The view that the statute imposes a special income tax has been accepted by all the lower Federal appellate courts. See, *e. g.*, *United Business Corp.* v. *Commissioner, supra; Williams Inv. Co.* v. *United States, supra,* p. 233; *A. D. Saenger, Inc.,* v. *Commissioner, supra,* p. 24. Cf. *United States*

[1] In 1928 the House proposed to differentiate between personal holding companies and all other corporations. In this connection, attention is invited to the fact that the statement made by Mr. Garner on the floor of the House, quoted from on p. 45 of the respondent's brief, relates to a proposed new provision for a tax on personal holding companies, supplemented by one on corporations, other than personal holding companies, which were availed of for the interdicted purpose. (See the bills as reported to and passed by the House, also the report accompanying the latter, H. Rep. No. 2, 70th Cong., 1st Sess., pp. 17–18.) Section 105 as thus reported proposed to retain, for the year 1927 only, the substance of the provisions of Section 220 of the Revenue Act of 1926, which is the same in substance as Section 104 of the Revenue Act of 1928 here under consideration. The Senate struck out the proposed new provisions of Section 104 of the House bill, changed the number of Section 105 to 104, and made it applicable to "each taxable year" to which the law applied instead of only to the year 1927. (See the bills as reported to and passed by the Senate;

v. *Hudson,* 299 U. S. 498, 500. In this view the statute is not a penalty at all.[2] Indeed, the court below did not really consider it to be such, but only a tax. True, it characterized the tax as "highly penal" in its nature, but nevertheless considered it to be a tax. Cf. *Helvering* v. *Mitchell,* No. 324, October term, 1937, decided March 7, 1938, and particularly note 15 thereto, wherein the decision of Judge Learned Hand in *United Business Corp.* v. *Commissioner, supra,* was referred to for an exposition of the nature of the provision.[3]

The tax is laid on income, and is imposed for revenue purposes. It was pointed out in the Government's brief in the *Mitchell* case, p. 31, that to deny to Congress the power to impose a higher tax in cases where fraud is the basis for such imposition would cast doubt upon the theretofore unquestioned power of Congress to deal in an appropriate civil manner with numerous types of tax evasion resulting from fraud. This is no less true of cases which do not involve fraud, but only a purpose of

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also the report accompanying the latter, S. Rep. No. 960, same Cong. and Sess., pp. 25–26.) The Senate amendments are numbered 68–70, inclusive. The House receded from its disagreement thereto. (See Conference Report, H. Rep. No. 1882, same Cong. and Sess., p. 1, also the statement of the managers on the part of the House appended to this report, p. 14.) The Court needs hardly to be informed that we are not here dealing with an undistributed profits tax.

[2] A contrary view has been expressed by a district court. See *Charleston Lumber Co.* v. *United States,* 20 F. Supp. 83, 87 (S. D. W. Va.).

[3] Reference has already been made to the *Mitchell* case in note 2 on p. 10 of the Government's brief in chief.

avoiding a tax.[4] If the legislative history of this provision as set out on pp. 77–123 of the respondent's brief proves anything, it proves the truth of the President's statement in his message to Congress of March 3, 1936 (Br. 113) that "This method of evading existing surtaxes constitutes a problem as old as the income-tax law itself." The hitherto futile efforts of Congress adequately to prevent the use of such methods seem only to prove beyond peradventure the vast extent of the evasion, which, as the President pointed out in the same message, in one year alone deprived the Government of $1,300,000,000 in revenue. It would therefore seem idle for the respondent to contend that there is no historic basis or justification for the law as a revenue measure.

The opinion of Congress that the tax here in question is necessary in order to protect and supplement the revenues is beyond challenge. And, by the same token, the classification is entirely reasonable. It is to be observed that the higher rate, or rather the special income tax, is laid upon the income of corporations thus availed of because that income includes amounts which, had they been distributed, would have been subject to another tax. Thus a

[4] It is clear that the tax here does not have fraud as its basis. That was the basis of the tax imposed by Section II–A (2) of the Tariff Act of 1913, c. 16, 38 Stat. 114, 166; but by Section 220 of the Revenue Act of 1918, c. 18, 40 Stat. 1057, the requirement of proof of fraudulent intent was dispensed with. The reason for this is explained in S. Rep. No. 617, 65th Cong., 3d Sess., p. 5, already referred to in note 2, p. 10, of the Government's brief in chief.

clear differentiation is made between income which does not include such items and income which does, and that differentiation is the basis for the difference in tax treatment. Although the rate is high, no one has ever questioned the power of Congress to fix such a rate, and the respondent does not do so.

It is therefore clear that this tax is valid, because we are dealing with a proper subject of taxation, namely, income; because the exaction is designed to protect and augment the revenues; because there is a valid classification, namely, income including items that but for the purposeful failure to distribute them would be subject to another tax; and because the rate is incontestably valid. It is thus apparent that the respondent has entirely misconceived the nature of this tax when it asserts that "it is a direct tax on a purpose, or state of mind" (Br. 40).

Nor is the statute open to the respondent's objection that it is so indefinite as to standard or formula as to render it void under the Fifth Amendment because it is so unreasonable, arbitrary, and capricious as to deprive the respondent of its property without due process of law (Br. 62). The same contention was rejected by the Circuit Court of Appeals for the Second Circuit in *United Business Corp.* v. *Commissioner, supra.* There, as here, the taxpayer relied upon the decision of this Court in *United States* v. *Cohen Grocery Co.*, 255 U. S. 81, to support its contention that the statute was too indefinite to lay down a consitutional criterion of

tax liability. In disposing of this contention, Judge Learned Hand said (p. 756):

> The argument misconceives the scope of those decisions. Standards of conduct, fixed no more definitely, are common in the law; the whole of torts is pervaded by them; much of its commands are that a man must act as the occasion demands, the standard being available to all. The vice of fixing maximum prices is that it requires recourse to standards beyond ascertainment by sellers, by which therefore they cannot in practice regulate their dealings. That is not true of the reasonable needs of a business, which is immediately within the ken of the managers, the supposititious standard, though indeed objective, being as accessible as those for example of the prudent driving of a motor car, or of the diligence required in making a ship seaworthy, or of the extent of proper inquiry into the solvency of a debtor.

Cf. *Williams Inv. Co.* v. *United States, supra,* p. 232.

In the case of *Old Dearborn Co.* v. *Seagram Corp.,* 299 U. S. 183, this Court distinguished the *Cohen Grocery Co.* case, *supra,* as well as the case of *Connally* v. *General Const. Co.,* 269 U. S. 385, 390, also relied upon and quoted from by the respondent (Br. 65). In the *Old Dearborn Co.* case, the contention of fatal vagueness and indefiniteness was primarily directed against the phrase "fair and open competition." The Court said (p. 196) that the point was shown to be lacking in substance by the

very reasoning in the *Connally* case, at pp. 391–392, and the cases there cited, referring specifically *inter alia* to the *Cohen Grocery Co.* case and quoting from p. 92 thereof to the effect that, "for reasons found to result either from the text of the statutes involved or the subjects with which they dealt, a standard of some sort was afforded." And, by way of illustration, the Court pointed out that it had never regarded such phrases, as "fair and open competition" and "unfair *methods* of competition," as being fatally uncertain. If so, how can it be contended that, having regard for the text of the statute and the subject with which it deals, the interdicted purpose is insufficiently described, either as to character of the corporation, kind of tax avoided, or type of accumulations that fall within its purview?[5] Nor is the basis for invoking the presumption less certain, for it is based upon a disclosure that the accumulations were "beyond the reasonable needs of the business," a fact no more difficult of ascertainment than many other questions ~~assigned~~ ARISING under the Revenue Acts. See *Wil-*

[5] The description of other subject matters of taxation depending on purpose is less certain. Take for example, such statutory provision as Section 302 (c) of the Revenue Act of 1926, c. 27, 44 Stat. 9, requiring the inclusion in the gross estate of a decedent of the value of property "To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth." Cf. *United States* v. *Wells*, 283 U. S. 102.

liams Inv. Co. v. *United States, supra,* p. 232; also *United Business Corp.* v. *Commissioner, supra,* p. 756.

Furthermore, the standard for which the respondent contends would require definiteness in the statement of the relationship between (1) capital and surplus on the one hand and volume of business on the other; (2) reserves and amounts required for expansion, obsolescence, depreciation caused by depressions and recessions, losses caused by strikes, walk-outs, fire, flood, hold-ups, thefts, embezzlement, drought, famine, and other conceivable perils that a business might encounter; and (3) the amount of dividends that must be paid and earnings, in order to avoid the penalty. In short, the respondent contends for a rigid formula, all of whose elements are definitely ascertained and fixed in advance, and which, at the same time, is so all inclusive as to comprehend every conceivable situation in which the special tax is to be imposed. We submit that the charge of indefiniteness is as pointless as the suggestion of the necessity for such a formula. No such standard would be required even in a criminal case. In *Nash* v. *United States,* 229 U. S. 373, 377, the Court said:

> But apart from the common law as to restraint of trade thus taken up by the statute the law is full of instances where a man's fate depends on his estimating rightly, that is, as the jury subsequently estimates it, some matter of degree. If his judgment is

> wrong, not only may he incur a fine or a short imprisonment, as here; he may incur the penalty of death.

See further, in addition to the cases already cited, *Kay* v. *United States,* No. 61, October term, 1937, decided January 31, 1938.

It is clear, therefore, that the statute is valid as a special income tax Act.

(B) THE STATUTE IS NECESSARY TO IMPLEMENT THE PROVISIONS OF THE LAW TO PREVENT TAX AVOIDANCE

The statute may be justified as necessary to implement the collection of the income tax. See *Williams Inv. Co.* v. *United States, supra,* p. 232. As was said in *Almours Securities* v. *Commissioner, supra,* p. 429:

> The subject is within the constitutional power of the legislative department. It is the duty of the Congress to determine what means are appropriate to carry out the purpose of the revenue acts. The end being legitimate and the means being plainly adapted to that end, we think the law is constitutional.

What has been said above (p. 6) to demonstrate the reasonableness of the classification is equally applicable to support the validity of the measure as a means of preventing tax avoidance. The specific objection which the respondent makes to the application of the section to operating companies is that its purpose and effect is not to prevent tax avoidance, but merely to "control and regulate the

dividend policy of domestic corporations so that income not otherwise existing or taxable under the revenue laws and under the constitution may be created and be subjected to taxation" (Br. 53–54). The cases which the respondent relies on in this connection go to the proposition that Congress may not, in order to prevent the doing of an otherwise lawful act, *not within its control,* impose a penalty upon the doing of such act in the guise of a tax. Such, for example, is the *Child Labor Tax Case,* 259 U. S. 34, and the decisions which have followed it (Br. 50–52). No such situation is presented here. It is indisputable that Congress has power to tax stockholders on dividends received from corporations and that it is possible for operating companies to be availed of for the purpose of preventing the imposition of such a tax upon its stockholders by permitting its profits to accumulate. And it cannot be gainsaid that the statute is designed effectively to prevent such avoidance. What the respondent is saying is that Congress is powerless to implement the statute by striking at the point where the blow will be most effective. Its contention that there is no relationship between the tax imposed upon the corporation and the surtaxes upon the shareholder is so obviously untenable as to require no refutation. In any event, it has been effectively disposed of by the Circuit Court of Appeals for the Second Circuit in the *United Business Corp.* case, p. 756.

It is clear, therefore, that the statute is valid as an implement to prevent tax avoidance.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that there is no sound objection to the validity of the statute.

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